Mongolia VAT Assignment Final Report
Analysis and Recommendations

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Executive Summary

The VAT Law in Mongolia has many positive features consistent with a well-constructed and well-functioning VAT. However, in the course of the assignment, a number of issues were identified where major problems in the operation of the VAT have emerged. The purpose of this assignment and this report is to identify the problems and to recommend changes to rectify the situation.

The key issues examined during the course of the assignment and the main recommendations are described below.

1. VAT Refunds – Policies and Procedures

The payment of refunds to taxpayers in an excess credit position is an integral part of all VATs. Although Mongolia does pay refunds to taxpayers in some circumstances, the payment of refunds is sporadic. In most cases, taxpayers are expected to carry forward the excess credit indefinitely until they can offset the excess credit amount against other taxes.

The VAT Law indicates that excess credit returns are to be (1) carried forward to offset future VAT liabilities, (2) used to offset other taxes owing, or (3) paid as refunds to the taxpayer. However, the law is not clear on the conditions that must apply for a refund to be paid.

The VAT Law states that the Ministry of Finance should allocate 30% of VAT revenues for the payment of refunds to taxpayers. However, refunds are considered by the Ministry of Finance and by the government generally, to be a cost incurred by the GDNT, and when budgets are tight, funds available to pay refunds may be restricted.

This perception that VAT revenue stands on its own and refunds are a cost to be treated separately is conceptually flawed. Refunds are an integral part of the calculation of VAT revenues. The VAT provides a credit to businesses for the VAT they incur on their taxable purchases. It is immaterial whether this results in lower VAT paid by a particular taxpayer, or results in a refund to another taxpayer (e.g., because it is an exporter and has no VAT on sales). In each case, the taxpayer is entitled to the credit for the VAT it pays on its inputs.

That said, it is important for the GDNT to have an administrative system in place to prevent the payment of fraudulent or exaggerated refund claims. To limit the number of refund claims to be processed by the GDNT, it is common under VATs for taxpayers to be required to carry forward excess credit claims for a reasonable period of time to be deducted against VAT otherwise payable in subsequent periods.

However, exporters will typically be in a permanent refund position because their export sales are zero rated under the VAT law. It is common under VATs for exporters to be paid refunds promptly, so that they do not incur a cash flow cost, resulting in a reduction of the international competitiveness of the country's exports.

The final report recommends:

- Shifting the responsibility of paying refunds to the GDNT from the Ministry of Finance, and the creation of a reserve account within GDNT to budget for future refunds of VAT;
- That the GDNT transfer to the Ministry of Finance the VAT revenue net of refunds and net of the change in the reserve account;
- Changes to the VAT Law be made to specify more clearly the conditions when VAT refunds will be paid out;
- Refunds to be paid to "Priority Refund Claimants" (primarily large-refund exporters) promptly each month, and to other taxpayers once they have been in an excess credit position for 6 consecutive months;
- A set of procedures (described in the Report) be implemented to process refund claims by Priority Refund Claimants and other taxpayers; and
- A proposed treatment to deal with specific taxpayers that have accumulated very large excess credit claims, whereby the VAT incurred in the future will be refunded regularly, and steps be taken to pay off the existing accumulation of excess credits over time.

2. Voluntary Registration / Start-up Businesses

Like most VATs, the Mongolian VAT specifies a threshold (10 million Tgs) of taxable sales revenue above which businesses are required to register for VAT. It also explicitly permits businesses below the threshold to register voluntarily provided they have proper bookkeeping and are not engaged exclusively in exempt activities.

However, applications by businesses under the threshold to register have often been denied. This has been a particular problem for start-up businesses who, in reality, are large businesses with substantial purchases, but who have not yet made any sales.

Refusing to allow such start-up businesses to register is contrary to the basic principles of a VAT. In effect, it results in the business paying an unrecoverable 15% tax on its initial investment costs. This would significantly reduce the attractiveness of Mongolia as a location for foreign investment, particularly for capital-intensive industries. Moreover, it does not apply evenly in this regard because businesses making new investments in certain circumstances will be able to claim full input credits (e.g., existing businesses with taxable sales).

The final report recommends:

- That the VAT Law be amended to clarify that voluntary registration by businesses with under 10 million in sales is permitted; and
- That start-up businesses be permitted to register and be subject to the normal rules for claiming refunds (as set out in Section 1 above).

3. Other Registration/ Small Business Issues

The assignment entailed an examination of several additional issues pertaining to registration procedures and the treatment of small businesses under the VAT.

The final report recommends:

- That the registration threshold should be kept at its current level – 10 million Tgs. It is noted that the natural growth in the number of taxpayers should continue to increase the number of taxpayers by approximately 17-20% per year;
- Some minor technical changes to allow more time for taxpayers crossing the threshold to apply for registration and for the GDNT to register them;
- Imposing a 2% tax on the gross taxable sales revenues of unregistered small businesses, with sales above 5 million Tgs, in order to reduce the differential tax treatment between those businesses just over the threshold, and those below the threshold;
- That as a general rule, no credit be given to newly registered businesses for the VAT incurred on inventories or capital prior to registration. However, a special transitional rule is proposed for new registrants in say, an initial period of 6 months, to permit credits to start-up businesses that would have registered if they had been allowed;
- That group registration be permitted, where one entity in a related group would be permitted to register on behalf of all the entities. However, to qualify for this treatment, all the entities in the group would have to be entitled to claim full input credits (e.g., no financial institutions or other entities making exempt sales could qualify);
- Rules governing the conditions that taxpayers could apply to be deregistered, and the GDNT could deregister a taxpayer when it falls below the threshold.

4. Refund for Consular Offices and Diplomats

During the assignment, an examination of the current policies and procedures for providing relief to Consular Offices and Diplomats located in Mongolia. It was concluded that the current treatment is reasonable in the circumstances. To the extent that it is decided to extend the refund for local purchases to cover personal-use items, the final report recommends a treatment whereby the refund would be limited to bona fide diplomats with proper diplomatic credentials.

5. Selected VAT Exemptions

During the assignment, the scope of various exemptions and the administrative implementation of these provisions were examined in detail. The key points arising from the review are set out below:

A. Exemption for Residential Rent

The VAT law exempts residential rent, as is common in many VAT jurisdictions. However, there is no denial of the input credits for a residential property owner that is able to be VAT registered. This is peculiar in that it effectively allows VAT to be recovered on expenses such as electricity, where they are included in the rent. The VAT on these expenses would not be recoverable if paid directly by the tenant.

The final report recommends:

- Continue the exemption, but deny input credits for expenses by the landlord.

B. Exemptions for Educational Services/ Medical Services

The VAT Law exempts educational services and medical services. These are common exemptions in VAT jurisdictions. However, they are prone to many debates over the borderline between taxable and exempt services. For example, should driver training for automobiles be considered as an exempt educational service.

Apart from such borderline issues, it is understood that entities such as hospitals and educational institutions also provide other business activities, which normally would be taxable –e.g., cafeteria services, drug stores, parking lots.

The final report recommends:

- That the GDNT consider limiting the exemption for educational services to formal education situations – e.g., courses offered by schools, universities.
- Where a medical or educational institution operates a taxable business (e.g., drug store, cafeteria) on its premises, it should register and charge VAT.
- The GDNT should consider exempting space rent charges by educational institutions or hospitals. This will allow such an institution to rent out space to other businesses without requiring the institution to register or pro-rate input credits relating to its space rentals.

C. Exemption for Official Development Assistance (ODA) Projects

The current system of exempting imports by ODA project contractors and allowing them to issue special VAT exempt purchase invoices to suppliers was examined. Although it appears to be functioning acceptably at this time, it is quite labour-intensive and prone to problems as the number of projects increases.

The final report recommends:

- For imports, a system of vouchers would be provided to project contractors, based on estimates of tax on imports developed by the donor and the Ministry of Industry. The project contractor would import the equipment and materials for the project in the normal fashion, and would simply pay Customs the VAT and

import duties on the equipment using GDNT vouchers. This would streamline the handling of imports for the project contractor;

- More importantly, for local purchases, rather than use a system of special "exempt" invoices, a streamlined refund system would be put in place whereby the project contractor would be paid refunds promptly on a monthly basis for the VAT paid on such purchases (providing the refund claim was within the parameters established at the outset by the donor and the Ministry of Industry).
- Alternatively, if the above streamlined refund system for local purchases is not sufficient to persuade donors that the tax would be recovered by the contractor, an "advance refund system" could be implemented whereby the project contractor would receive advances for the VAT to be paid on its purchases (based on estimates of purchases agreed to in advance).
- The report outlines the procedures to be followed to operate such systems.

D. Exemption for Heavy Equipment for Priority Industries

Currently, there is a list of selected heavy equipment that may be imported or purchased locally without VAT by firms in selected "priority" industries. The purpose of this list is to reduce the up-front VAT burden on firms in the priority industries.

The final report recommends:

- The repeal of this exemption, if the refund system (as set out in section 1) is implemented and the exemption for gold is repealed (as set out in section 5(F)).

E. Exemption for Agricultural Producers

Agricultural producers are exempt from charging VAT on their sales. However, by consequence, they do not register and cannot deduct the VAT they pay on their inputs. This results in their costs being higher than would otherwise be the case. Various approaches to address this problem were considered, including a notional input credit which would be paid to processors purchasing materials from primary producers.

However, on balance, the final report recommends:

- Primary producers accumulate their VAT purchase invoices and be given a credit for the VAT they pay on their inputs against their income tax otherwise payable. If the credit exceeds their income tax payable, they would be given a refund.

F. Exemption for Gold Sales

There have been numerous changes to the VAT treatment of gold since the implementation of the VAT. An important element of the current exemption appears to be to use the denial of input credits resulting from the exemption to supplement the revenue from the royalty tax on gold.

This report does not question the right of the Government of Mongolia to receive an appropriate revenue stream from the mining of gold in Mongolia. However, the use of a VAT exemption to partly obtain this revenue stream (i.e., through the denial of input credits) causes a serious flaw in the operation of the VAT. In addition, given the lack of transparency of this mechanism to obtain revenues, it may be very difficult for the authorities to know how much revenue they currently receive, or how much they will receive, as a result of the exemption.

In addition, it seems that any such tax on mining should be lower for companies that contribute more to the development of the Mongolian mining sector, and higher for companies that merely exploit known and easy-to-mine mineral reserves. However, the VAT exemption achieves exactly the opposite effect – the more that a mining company puts into developing the resource (i.e., exploration, digging mines, etc.), the more unrecoverable VAT it will incur. Conversely, a company that merely exploits a known reserve with gold deposits close to the surface will bear much less unrecoverable input VAT.

The final report recommends:

- The repeal of the exemption with the result that gold sales would generally be taxed in the normal manner – i.e., taxable if sold domestically, zero-rated if exported;
- The zero-rating of sales of pure gold (above a specified purity level) to the Mongol Central Bank.
- The consideration of the current Royalty tax rates, as necessary, to obtain the desired level of revenue from this resource.

The report also considers the transitional VAT issues if the gold exemption is repealed – i.e., the treatment of VAT paid on equipment, etc., purchased or imported during the past period while gold has been exempt. A tentative approach is put forth in the report for the GDNT to consider.

G. Exemption for Tour Operators

The VAT Law exempts services by tour operators providing tours to foreign tourists. The purpose of the exemption is to make Mongolia a more attractive destination for foreign tourists.

However, the exemption for "tour operators" provides them a competitive advantage relative to "tour agents" who are not eligible for the exemption. The inequality is particularly problematic if tourists in Mongolia have the choice between tour operators (non-taxable) and tour agents (taxable). Consequently, tour agents are pressing the GDNT to be included under the exemption.

The final report recommends:

- That the tour operator exemption be limited to tours purchased and paid for outside Mongolia (e.g., sales of Mongolian tour packages sold by agents in Japan). This would achieve the objective of attracting foreign tourists to Mongolia, while not creating a competitive bias for the purchases once they are in the country.

H. Rules for Allocating Inputs between Exempt and Taxable Activities

Under VAT, businesses are entitled to claim input credits for VAT paid on inputs used in VAT-taxable activities. They are generally not entitled to claim input credits for VAT paid on inputs used in exempt activities.

The question arises as to what input tax credits should be claimable where a business is involved in both taxable and exempt activities. Administratively, the GDNT have been using a revenue-based allocation formula to compute the input credits claimable by businesses in this situation.

While such revenue-based allocation methods are reasonable and simple to use in certain circumstances, in other circumstances, they can give very skewed results and are prone to abuse.

The final report recommends the following three-step allocation method used in many countries:

- First, directly attribute to the taxable and exempt activities respectively, any inputs that are used exclusively in that particular activity;
- Second, allocate multi-use inputs that can be to some extent identified with the particular activities (for example, rent may be allocated between taxable and exempt activities based on the floor space used by each activity); and
- Third, allocate any residual "non-attributable" inputs using a formula (either revenue-based or based on the distribution of inputs based on the first two steps above).

6. Non-Deductible Input VAT for Automobiles

The VAT Law states denies input credits for acquisitions of automobiles, and parts therefor. The denial of input credits for automobiles is reasonable, given that automobiles are generally used significantly for the personal use of the owners or employees. Denying an input credit up front avoids the necessity of having to pro-rate the value of the automobile between the business-use and the personal-use components.

However, the current provision also denies input credits for automobiles that are purchased for resale, or lease. This is problematic as it results in double taxation of the vehicle.

The final report also considers the situation for taxi companies. Conceptually, taxi companies should be entitled to input credits for their acquisitions of vehicles and should charge VAT on the daily payments charged taxi drivers. However, there could be significant transitional problems for drivers if they are required to pay tax on their current daily fee (which already includes an element of tax – i.e., the unrecoverable tax paid by the taxi company).

The final report recommends:

- The modification of this rule so that it does not apply to automobile dealers that sell or lease vehicles (i.e., they would be entitled to claim input tax credits).
- A transitional rule would be implemented for taxi company dealers, who sell their vehicles to drivers by charging them a daily fee – the input credit would be available only for automobiles acquired after the date of the change, and VAT would be applied on the daily fees only for those automobiles acquired after the date of the change.

7. Treatment of International Telecommunications

During the assignment, the current rules regarding the tax treatment of international telecommunications services in Mongolia were examined. The Mongolian VAT treatment was found to be appropriate and consistent with international practice – i.e., it taxes telecommunication services that originate or terminate in the country, and are billed in the country. The international practice recognizes that an international telecommunications service is, in effect, consumed partially in both countries. As a matter of practicality, and to avoid double taxation, the service is typically taxed in the country where the service is billed.

8. Treatment of Gifts, Promotional Goods and Samples

There are a number of situations where a business will "give" away goods in order to promote its products or business. For example, a business may give away promotional T-shirts, pens, etc., bearing the logo of the business to prospective customers.

The Mongolian VAT treatment, which generally requires VAT to be payable on the normal value of these gifts is consistent with international practice.

However, the VAT Law appears to apply more generally to businesses' distributions of samples. Generally VAT does not apply to a business' give-aways of samples of its own product, in forms not commonly sold, to promote its products (e.g., small samples of shampoo or household cleaners). This is typically viewed by VAT jurisdictions as a non-taxable transaction. (Note though that full input credits are permitted for the production or acquisition of the samples).

The VAT Law does not directly contemplate the situation where a business gives away a free item of inventory to a customer that is buying another item (e.g., buy two for price of

one). In these situations, the VAT should apply to the price paid. This is effectively the same as a 50% off sale and should be treated as such.

The final report recommends:

- That the GDNT should review its treatment of free promotional goods, and should consider not applying VAT on samples given away, nor for items given away as part of a "buy one, get one free" pricing policy.

9. Penalties

During the assignment, the penalty structure for the VAT was examined. In particular, the penalties imposed in Article 13 of the VAT Law were reviewed.

The following structure of penalties is common to many VAT jurisdictions:

(1) modest flat-rate administrative penalties are imposed on taxpayers failing to comply properly and on time with their obligations (e.g., late filing of returns);
(2) a penalty, expressed as an interest rate charged on the amount of tax outstanding, is imposed on taxpayers that fail to remit the proper amount of tax;
(3) very significant penalties, expressed as a percentage of outstanding tax, are imposed for more serious forms of tax evasion (e.g., failing to register, collecting VAT where not registered); and
(4) interest, calculated using a rate based on the prevailing market rate of interest, is imposed on all tax amounts owing (in addition to the above penalties).

The penalties set out in Article 13 are not structured in a way to be effective. In particular, the penalty imposed on businesses that fail to register varies significantly in its impact, depending on the relative value-added of the non-compliant business. In fact, a service business that is non-compliant and is caught by the tax office may well be better off under this penalty treatment, than it would if it had been compliant. This does not encourage voluntary compliance. The penalty imposed on unregistered businesses that falsely charge VAT is much more severe but it is inflexible in its structure – e.g., it can result in only a modest penalty if the behaviour is caught by the authorities early.

The final report recommends:

- Penalties be implemented for these infractions which are more in line with international practices, as set out by the above structure of penalties; and
- The review by the GDNT of their other penalties for non-compliance, based on the types of penalties described above.

10. Administrative Issues

Several consulting assignments have examined and made numerous recommendations on the tax administration system in Mongolia. The examination in this assignment is more

narrowly focused, pertaining exclusively to the VAT administration system and recent proposals by the GDNT to enhance its effectiveness.

Many of the following recommendations, particularly involving the implementation of new procedures and the reallocation of responsibilities within the GDNT and the Capital City Tax Office, will require careful planning and consideration and may take more time to be implemented.

The final report examines the following areas of VAT administration:

- Organizational issues/ tax officer responsibilities
- Training requirements, and
- Assessment of new Tax Invoice/ Computer Cross-checking Initiative

The final report recommends:

- To improve the expertise in the VAT within the GDNT, an increase in the number of tax officers specialized in VAT, and the creation of a VAT sub-unit in the GDT responsible solely to deal with VAT issues;
- A team be established within the Tax Auditing Division specifically responsible for VAT audits;
- Changes be implemented to automate the receipt and processing of VAT returns in the Large Taxpayer Office and the Capital City Tax Office;
- The reallocation of some tax collection staff in these offices that are currently involved in the receiving returns directly from taxpayers, to the monitoring of non-compliant taxpayers or to performing VAT audits.
- The establishment of a separate VAT audit group in the tax offices, which would focus on single-issue VAT audits.
- Training be given to VAT officers in all tax offices in the basic operation of the VAT, including any changes made to the VAT coming out of the recommendations in this Report.
- Training be provided to auditors in VAT single tax audit techniques;
- To the extent that the procedures for receiving VAT returns are changed, as per the recommendation above, procedures manuals will need to be prepared, and training provided to staff involved in the receiving and data entry of VAT returns.
- Training will also be required for existing Tax Collection staff in the Large Taxpayer Office and Capital City Tax Office whose responsibilities change (as described above);
- To the extent that the procedures for processing refund claims (outlined in Section 1) are adopted, training will be required for audit staff in these procedures.
- Regarding the use of serialized VAT invoices, rather than entering data from all invoices received, the GNDT should selectively enter data, which it can then cross check on single-tax VAT audits.

Mongolian VAT Assignment – Final Report

May 5, 2003

1. VAT Refunds – Policies and Procedures

A. Background

Under VATs, the taxpayer can recover the input VAT paid on capital and operating expenses through the input tax credit mechanism (except where the inputs are in respect of an exempt activity). This is fundamental to the operating principles of the VAT.

Generally, the input VAT will simply be deducted from the output VAT thereby computing the net VAT payable with the return. However, in several circumstances, as described below, a business may be in an excess credit position on its VAT return.

There are a number of circumstances in which VAT excess credit returns arise:

- Exporters – they incur VAT on inputs but their sales are zero-rated because they represent consumption outside the jurisdiction. Consequently, exporters will always be in an excess credit position;
- Vendors of other zero-rated goods/ services – these vendors pay VAT on inputs but do not charge VAT on sales, potentially putting them in a credit position. Depending on the proportion of zero rated sales versus taxable sales that the vendor makes, the vendor may or may not be in an excess credit position on a particular VAT return;
- Businesses making large purchases of inventory – many businesses make periodic large purchases of inventory that is subsequently sold over several months. This will result in only temporary excess credits that will generally be quickly used up by VAT charged on sales in the following months;
- Businesses making large purchases of capital equipment– purchases of VAT-taxable equipment may temporarily put a business into an excess credit position, depending on how large the capital purchase is relative to taxable sales;
- Start-up businesses – where a business is in its start-up phase, (e.g., a manufacturer building a factory), it will incur large capital costs and purchases of inventory on which it will pay VAT, and it will have no sales from the operation on which it will collect VAT. Therefore, until it begins to make sales, it will be in a large excess credit position.

B. VAT Excess Credit Issues – General Treatment

There is nothing unusual about the input VAT that has been paid in such excess credit circumstances. The availability of a credit for VAT paid by a taxpayer should depend only on the use of the particular purchase, not whether the taxpayer is in a credit or debit position. There is no reason to discriminate between VAT paid on one business expense versus another (provided they are both for VAT taxable activities.)

In addition, from a fiscal perspective there is no difference between an amount of input VAT that is paid out as a refund to a taxpayer, and an amount of input VAT that reduces the amount of VAT otherwise receivable by the government. A tugrug paid out as a refund is the same as a tugrug not received.

However, there is one distinguishing factor of refunds that is important. Unless proper controls are in place, a VAT refund system can be the victim of fraud schemes. Therefore, although the conceptually correct way to handle excess credit claims is by paying prompt refunds to taxpayers, this has to be balanced against the need to ensure that fraudulent refund claims are not paid to businesses. In developing refund policies and procedures, the tax authorities must be given sufficient time to be satisfied that the refund claim is *bona fide*.

Where control systems permit, such as in Canada or New Zealand, VAT authorities pay all refund claims quite promptly. Generally, they do this by identifying *bona fide* businesses that the authorities know from past history will legitimately be in an excess credit position on a regular basis. The authorities know that even if there is any discrepancies in a particular refund claim, this can be resolved at the time of the next audit of the business. Consequently, all refunds claims for these taxpayers, up to a preset maximum, are paid promptly with little or no pre-auditing by the authorities. Irregular excess credit claims under a specific threshold are subject to a desk audit by tax authorities prior to payment. Larger refund claims and, in particular, claims by new businesses are subject to more rigorous investigations prior to payment.

To the extent that the payment of the refund is delayed beyond a prescribed number of days (e.g., after 21 days in Canada), interest on the refund is payable to the taxpayer. In VAT jurisdictions where control systems are less able to cope with large numbers of refund claims, immediate refunds are often limited to large exporters. These are priority refund claims for the authorities because the international competitiveness of exporters may depend on their ability to receive prompt VAT refunds from the government. Other businesses are typically required to carry forward excess credit claims to subsequent periods. Where the business has been in a continuous credit position for a specified period (e.g., 6 months), the authorities will audit the claim and then pay a refund. (A proposal for processing refunds in Mongolia is set out in Section 4 of this paper.)

The purpose of this carry-forward is not to make a cash flow gain at the taxpayer's expense. The purpose is simply to use the carry-forward to reduce the number of VAT refund claims that the tax authorities have to deal with each month. Many excess credit claims will be used up by VAT liabilities in the carry-forward period. Excess credits can also be offset against other tax amounts (e.g., Corporate Income Tax) during the period.

C. Refunds under Mongolian VAT Law

Under Article 11.4 of the VAT Law, if a taxpayer is in an excess credit position for a particular month, the tax authorities are required to either:

- Carry forward the excess to offset VAT liability in the succeeding month, quarter or year;
- Credit the excess against other taxes owed by the taxpayer to the government;
- Refund the excess to the taxpayer.

Articles 11.6 and 11.7 specify that the tax authorities shall have a special fund established, equal to 30% of the total VAT collections, from which it can pay out refunds.

Assessment

The Mongolian VAT sets out three possibilities for handling the excess credit, but it is not clear how long the excess VAT credit must be carried forward before the authorities must issue a refund from the special fund. In addition, there is no special treatment of large exporters to give them a more prompt refund.

Based on my discussions with tax officials and taxpayers, it appears that taxpayers are generally expected to carry forward an excess credit balance until it owes VAT or some other tax that it can use to offset the excess credit amount. Refunds are rarely paid to taxpayers.

The non-refunding of the VAT penalizes some businesses in particular situations but not other businesses in similar situations. For example:

- Exporters that also make domestic taxable sales likely are not in an excess credit position, but businesses that only export face a cash flow problem.
- Exporters with significant amounts of Enterprise Income Tax ("EIT") payable do not have a problem, but exporters with no EIT (i.e., because they are in a loss position) must face a significant cash flow cost waiting indefinitely for the refund to be paid;
- Taxpayers that have higher margins are less likely to be in an excess credit position than businesses with lower margins, because their input VAT will be a smaller proportion of sales revenue (and more quickly absorbed by VAT on sales);
- Existing businesses undertaking additions to capital investments (i.e., upgrades to existing capital) may be temporarily in an excess credit position, but because they continue to make taxable sales, the carry-forward will absorb the excess credit amount relatively quickly. In contrast, a new business in a start-up phase will face a major cash flow problem for an indefinite period of time.
- The problem for new start-up businesses will be worse for more capital-intensive industries compared to less capital-intensive industries.
- Finally, if group registration is permitted, a taxpayer in an excess refund position that is part of a related group will not face an excess credit cash flow problem, but a single taxpayer will face a cash flow cost waiting for the carry-forward to be absorbed.

In addition to the above inequalities, the non-payment of refunds can result in significant compliance problems, and undermine the general operation of the VAT. One taxpayer consulted during the assignment indicated that because of the perception that refunds are not being paid, some exporters refuse to pay VAT to their suppliers. The suppliers to the exporter do not issue VAT invoices, and do not remit VAT on the charges (nor would

they pay EIT on these sales). Consequently, because of the perceived inability to be paid refunds of VAT, non-compliance and revenue erosion pervades the entire tax system.

Recommendations

The GDNT should consider amending Article 11.4 to clarify the specific conditions where refunds will be paid to taxpayers. It is proposed that refunds would be paid in the following two scenarios:

(1) Refunds would be paid immediately to "Priority Refund Claimants" once the tax authority was satisfied the refund claim was valid. A "priority refund claimant" would be defined as a business with sales greater than 500 million Tgs per year, that on average exports more than 75% of its sales, and whose excess refund claim (cumulative) is over 50 million Tgs. [GDNT to modify values as appropriate]

(2) For other taxpayers, Article 11.4 should clearly specify the period of time the excess VAT credits would be required to be carried forward prior to the authorities paying a refund.

It is recommended that a refund be paid to the taxpayer if it has been in a cumulative excess credit position for 6 consecutive months. For example, if a taxpayer incurred a large excess credit in month 1, and after six months the credit still had not been used up, the residual would then be refunded.

At any time during this period, a taxpayer could request that the excess credit amount be applied to offset other taxes payable by the taxpayer.

In each case, it would be upon application to the tax office – the GDNT would not be required to automatically process a refund. (The tax return should be modified to include a box immediately under the excess credit carryover amount, which the taxpayer could check if it was requesting a refund.)

In both cases, the taxpayer's refund claim should be accompanied by a copy of the taxpayer's sales and purchase book for the relevant period (not the invoices).

The government's commitment to paying out refund claims should be publicized to taxpayers, in order to encourage compliance among taxpayers.

D. Budgeting for Refunds

Articles 11.6 and 11.7 state the amount should be paid from state budget and a 30% budget should be allocated to pay refunds. In discussions with officials, I understand that the refund amount is in effect treated as a cost to the treasury.

It is not appropriate to think of the gross VAT revenue collected before refunds as being the "VAT revenue amount" with refunds representing a separate cost. Rather, the true VAT revenue is the amount net of refunds payable.

Recommendation

Rather than set up a fixed fund from which refunds should be paid out, the Ministry of Finance should estimate its revenue yield from the VAT as the amount net of estimated refund payouts.

It seems most appropriate for the GDNT to be responsible for paying refunds, and for the GDNT to remit the net VAT amount, net of refunds paid or payable, to the Ministry of Finance.

To manage the payout of the refund amounts, the GDNT should consider setting up a "Refund Reserve Account" that it could use to pay future refunds of amounts currently being accumulated as carry-forward credits (i.e., for the 6-month accumulation). Under this system, each month the GDNT would track the gross amount of excess credits being carried forward. When refunds of credit amounts carried forward were paid to taxpayers or used to offset other taxes, this amount in the reserve account would be reduced. The amount payable to the Ministry of Finance would be the gross VAT collections in the period, net of the refunds paid out, and net of the change (plus or minus) in the amount of the refund reserve account. In this way, the government would never be faced with a one-time cash flow problem of having to pay out 6 months of refund claims out of a particular month's VAT collections.

E. Administrative Procedures for Handling Excess Credit Returns

a) Procedures for Processing Refund Requests from a "Priority Refund Claimant"

(1) When a taxpayer first applies for a refund claim as a Priority Refund Claimant, the tax office would first check if the refund claim amount were over 50 million Tgs. If it were less than 50 million Tgs, the refund claim request would not be processed further. (Note: if the taxpayer has been in an excess credit position for 6 months, go to section b.)

(2) The tax office would then check the compliance record of the taxpayer over the past year. If the taxpayer has been late in filing returns or paying taxes during the past the past year, its refund application would not be considered further as a Priority Refund Claimant (it could still receive a refund if in a credit position for more than 6 months).

(3) If the refund claim request is over 50 million, and the taxpayer has been compliant, the tax office would check the financial records of the taxpayer to confirm that its sales revenue for the past year (or its estimated sales for the coming year, if it is a new business) is over 500 million Tgs, and that exports constitute at least 75% of its sales.

(4) The tax office would then do an on-site investigation of the specific refund request to verify that the excess credit amount claimed constitutes a *bona fide* refund claim – i.e., checking VAT invoices from suppliers and Customs documentation on imports against the entries in the purchase book
(5) Also check the purchase entries to ensure no items are included for which input credits are not permitted (e.g., automobiles). Also, the purchases must be considered for reasonableness if they are for use in the taxpayer's taxable business activity.
(6) Once the GDNT has determined that the taxpayer constitutes a *bona fide* Priority Refund Claimant and that the refund amount is valid, the tax office would then check if the taxpayer owed any other taxes. If so, the refund amount would first be used to credit the other tax account, and the remainder would be refunded without further delay.
(7) The Master File would be amended to identify the taxpayer as a qualifying "Priority Refund Claimant". An expiry date of, say, 1 year would be assigned to the taxpayer's Priority Refund Claimant status.
(8) For subsequent refund requests, the tax office would confirm that the taxpayer had previously been established as a Priority Refund Claimant, and steps (4) - (6) would be used to verify and pay the refund request.

b) Steps for Processing Refund Requests from Other Taxpayers

(1) The Tax Office would verify that the taxpayer has been in an excess credit position for the past 6 months (including the current return).
(2) For first refund claims over 1 million Tgs, the tax office would do an on-site inspection of the taxpayer to verify that the taxpayer is a *bona fide* business with a valid explanation for the refund claim. For first time refund requests less than 1 million Tgs, and for subsequent refund claims over 1 million Tgs, skip step (2) and go directly to step (3) below (providing the taxpayer has been compliant and no problems identified in prior audits).
(3) The tax office would do a thorough examination of particular refund claim, verifying that all amounts recorded in the purchase books matches the refund request. For refund requests in excess of 1 million Tgs, it should request the taxpayer to provide copies of purchase invoices for selected large purchases. For large refunds, an on-site investigation of the taxpayer's records should be done to verify the most significant purchases.
(4) The tax office would check the purchase entries to ensure no items are included for which input credits are not permitted (e.g., automobiles). Also, the purchases must be considered for reasonableness if they are for use in the taxpayer's taxable business activity.
(5) The tax office would then approve the refund request for payment or, if there were any other taxes owing by the taxpayer, credit the refund amount against other taxes payable, and then refund the difference.

Streamlined Method for Handling Refund Requests

Note that many VAT administration systems use a streamlined system for processing refund requests by established taxpayers that have received refunds of VAT previously.

Under this streamlined system, during the review of the taxpayer's first refund request, the tax office would do an on-site investigation to confirm that it is a *bona fide* business, review the taxpayer's records, its estimated sales and its estimated excess credit amount per month. The tax office would then establish a reasonable "single refund claim threshold", below which subsequent refund requests would be routinely approved, or at most subject to a desk audit. A cumulative refund threshold would also be established, e.g., 10 times the single refund claim threshold. These data would be included in the taxpayer's record.

When the tax office received subsequent refund requests from the taxpayer, it would confirm that the refund request is under the thresholds previously established. The refund request would then be processed as a matter of routine, relying on future audits to catch any errors.

While this system works well for systems where there are large numbers of refund requests to be processed, in Mongolia, the number of refund requests is likely to be very small. Such a streamlined system may not be necessary for Mongolia at this time.

F. Specific Transition Issue

In discussions with tax authorities and taxpayers, it has been indicated that there is at least one VAT registered business that over the past year has accumulated a very large excess credit amount.[1] The business is in its start-up phase and is incurring very large VATable expenses, without making any VATable sales. Because it is in its start-up mode, the business has no EIT or other taxes against which the accumulated VAT excess credit can be applied. The payment of the refund to the taxpayer poses a significant cash flow problem for the government, and internally there is understandably much concern regarding the best way to proceed.

As discussed above, under the fundamental principles of a VAT, once the excess credit amount has been verified, a refund should be paid to start-up business within a reasonable amount of time. However, recognizing that the payment of the excess credit amount accumulated to date would pose a significant cash flow problem for the government, it is proposed that the government take the following two-pronged course of action. The tax authorities should consider:

(1) Taking steps to avoid the further growth of the excess credit amount; and
(2) Taking steps to deal with the present accumulated excess credit claim.

[1] This discussion assumes that the amount of the excess credit is valid. This should be reviewed to determine if all of the input VAT claimed is valid and for use in a taxable activity. See also the discussion regarding the exemption for gold sales and the recommendations therein.

(1) Steps to avoid the further growth of the excess credit amount

The excess credit amount currently outstanding may be very large, but if the business continues to incur VAT on inputs in the coming year without charging VAT on sales or being subject to EIT, the amount of the excess credit will grow dramatically in the coming year. It will then pose that much more of a cash-flow problem at that time. Consequently, it is desirable to take steps to avoid the further growth of the amount.

The most straightforward method for handling this would be to begin to pay refunds on a regular basis as the new excess credit claim amounts are received on VAT returns (e.g., beginning with the May 2003 return). Based on the proposed approach described above, a refund could be issued in say, July 2003, covering the period commencing January 1, 2003. Refunds could be issued for subsequent VAT incurred in regular 6-month intervals thereafter. This would leave the excess credit accumulated prior to January 1, 2003 to deal with (see (2) below).

Other approaches were considered but were all found to be unnecessarily complex. For example, one could allow the taxpayer to be treated in the same way as an ODA funded project (allowing it to import and purchase locally without incurring VAT on inputs). While this method would prevent further growth in the VAT excess credit amount, it would set a very dangerous precedent, i.e., other businesses might ask for similar treatment. Note that this method would entail the same fiscal result to the government as the refund. Consequently, this method is not recommended.

(2) Steps to Deal with the Accumulated Excess Credit Amount

The GDNT should consider entering into discussions as soon as possible with the particular taxpayer(s) to agree on an approach to handle the present accumulated excess credit claim.

For example, based on the discussion in (1) above, refunds would be paid for the period commencing January 1, 2003 and thereafter. To handle the excess credit accumulation prior to January 1, 2003, it may be agreed that the excess credit amount would be refunded in periodic installments over the coming 12 months. Alternatively, it may be agreed that some portion of the claim amount could be refunded over the coming 12 months, and the remainder carried forward indefinitely to be offset against VAT, EIT or other taxes payable in the future.

Given the circumstances, dealing in this way with the large accumulated refund claims would yield a result that is reasonably close to how the VAT is conceptually intended to work. In addition, the successful handling of this issue may send a positive signal to other potential investors in Mongolia that they will not have to bear VAT on their investment costs, thereby reducing uncertainty and improving the economic attractiveness of investing in Mongolia.

2. Voluntary Registrations and Start-Up Businesses

A. Voluntary Registration

While virtually all VATs exempt small businesses below a specified turnover threshold, the great majority of VAT's allow small businesses under the threshold to elect to register voluntarily for VAT. The main purpose of voluntary registration is to allow small businesses that are in the middle of the production-distribution chain (i.e., that sell to VAT-registered businesses) to recover the VAT on their inputs. This allows them to be part of the VAT system, and avoids tax cascading (because of non-recoverable VAT in the chain).

Voluntary registration can be a burden for the tax administration system, and is a particular problem if the small business doesn't have proper books and records. In this case, it will not be able to comply with the VAT requirements.

Article 4.4 in the VAT Law allows any person to register for VAT providing they are carrying on taxable business activities (i.e. other than exempt activities), regardless of their sales revenue, provided that they have satisfactory books and records. The intent of this provision is clear – to allow voluntary registration. However, Article 9.3, which exempts otherwise taxable sales by persons that have sales less than 10 million Tgs, is in clear contradiction to the intent of Article 4.4 as this Article would always prevent anyone under 10 million Tgs from registering. Consequently, if Article 9.3 were read strictly, Article 4.4. would be rendered completely ineffectual, which cannot be the intent of the legislation.

It appears that the tax offices have been reluctant to register any taxpayers voluntarily, perhaps as a result of this contraction in the law.

Recommendation

It is recommended that the GDNT permit voluntary registration, for businesses with proper bookkeeping, as is provided in Article 4.4. Article 9.3 should be amended clarify that it exempts sales by businesses under the threshold "unless the person has applied for registration and been registered by the tax authorities.").

B. Start-Up Businesses - Registration

A question has arisen as to whether large businesses in the start-up phase, prior to making any sales, should be permitted to register voluntarily to recover the VAT on their investment costs.

VAT is intended to apply to consumption. One of the key benefits of a VAT over sales and turnover taxes is that it allows the VAT to be removed from business investments, thereby improving economic competitiveness and removing distorting effects.

The Mongolian VAT generally allows VAT to be recovered on capital expenditures. Consequently, it is inconsistent to disallow start-up businesses to register and recover the tax they pay on their capital investments. Doing so would result in a substantial discrimination against initial investments by start-up enterprises.

It would result in many distortions and inequities. For example, a start-up manufacturer that builds a factory would face unrecoverable tax equal to the tax on its initial investment. However, if an established manufacturer in the same industry decides to build a second plant, it would not face this problem because it will already be registered and will have output VAT from its existing business against which it can deduct the VAT on its new investment. VATs should avoid this type of differential tax treatment between competing businesses.

One approach suggested during the assignment was to disallow a start-up business from registering until it reaches the 10 million Tgs threshold, but then allow it to claim input credits for the VAT paid on its purchases prior to registration. Although this would allow a business to eventually claim the credit, this approach would have many drawbacks.

- First, it would result in a very large accumulated refund claim for the tax administration to deal with when the business finally registered.
- Second, if the start-up phase were very long (e.g., 1-2 years), it would be more difficult to check all the purchase invoices going back to the beginning of its start-up period.
- Third, until the business reached the 10 million Tgs threshold, its sales would be exempt, potentially allowing it a competitive edge over other businesses.
- Finally, when it crossed the threshold and registered for VAT, under this option it would be allowed a credit for the VAT it had paid prior to registration. However, this would effectively zero rate the 10 million Tgs of sales it made prior to registering. Presumably the tax authority could try to pro-rate the credit to disallow the portion of operational expenses related to the exempt sales during the period, but this would be a complex task for the administration.

  Recommendation

  Such start-up businesses applying for registration should be permitted to register prior to incurring investment expenses.

  They should be allowed to file refund claims under the general rules set out in Section 1 of this paper, i.e., every 6 months.

3. Other Registration/ Small Business Issues

A. Registration Threshold

The threshold was set at a level of 15 million Tgs when the VAT was first implemented in July 1998. There were 1718 VAT registered taxpayers at that time. By May 1999, there were 1993 registered VAT taxpayers, an increase of 16% (19% annual rate of growth). In May 1999, the threshold was reduced to 10 million Tgs. During the

following months, the number of taxpayers increased significantly. For the 12 months following the reduction in the threshold, the number of taxpayers increased by 26%. Since then, the annual rate of growth in the number of taxpayers has been approximately 18-19%. The total number in December 2002 was 3849 and it is estimated to be approximately 4000 as of April 2003.

The Korea Institute of Public Finance ("Korean IPF"), based on their analysis of data for the year 2000, suggested that it might be desirable to lower the threshold to 8 million tgs.[2] Based on their data, this would increase the number of taxpayers by about 16% at that time.

However, it is noteworthy that at the end of 2000, there were only 2651 registered taxpayers. This number has increased on its own by 50% since December 2000, to 4000 registered taxpayers now. Moreover, if the number of VAT taxpayers in Mongolia continues to increase at a rate of 17-20% each year, there will be over 4500 taxpayers by the end of 2003 and approximately 7500 taxpayers by the end of 2006.

Mongolian tax administration procedures, such as the method of receiving and processing VAT returns, are quite labour intensive. The potential negative impacts on the tax administration system of decreasing the threshold to bring in a significant number of new VAT taxpayers, while such labour intensive procedures are used, should be carefully considered by the GDNT.

Recommendations

Although a modest reduction in the threshold (i.e. to 8 million tgs) would not be unreasonable, on balance, it is proposed that Mongolia should keep the threshold at the current level of 10 million, and let the natural growth in the taxpayer population increase the number of VAT taxpayers in the coming years.

In addition, rather than lowering the threshold to increase taxpayers and revenue, it may be better for Mongolian tax offices to use their resources to identify taxpayers that are over the threshold and that have not registered, or to focus on auditing and other forms of compliance enforcement.

B. Policies Regarding the Registration of Small Businesses Crossing the Threshold

The wording of Article 3.1.9 in the VAT Law appears to require a small business to check its sales daily to determine if it sales during the previous 12 months exceed the threshold. Under Article 4.2, if, at any time, its sales over the previous 12 months exceed 10 million tgs, it then has 10 days to apply to be registered. Under Article 4.3, the tax office must approve its registration and send it a registration certificate within 3 days.

Although the legislation technically requires the business to monitor its sales continually, as a practical matter, I understand that the tax office only requires businesses to consider their month-end sales (i.e., daily checking is not required).

[2] Korea Knowledge Partnership Project, "Tax System and Intergovernmental Fiscal Relationship in Mongolia: Assessments and Suggestions", p. 12

Under Article 3.1.9, the business becomes a "value-added taxpayer" when it reaches the 10 million Tgs threshold even if it does not apply for registration. This is very appropriate as it requires the business to remit VAT on its sales even if it does not register (i.e., it gains no advantage from not registering).

Recommendation

Many countries provide more time (e.g. one month) for a small business to assess whether it has exceeded the threshold. The GDNT should consider whether the 10-day period is practical for small businesses and whether it could allow a longer grace period to apply for registration. In addition, it should consider removing the 3-day period for the tax office to issue a registration certificate.

The GDNT should consider modifying Article 3.1.9 to state that the business becomes a taxpayer 10 days after the threshold has been crossed (or such longer period if a change in the grace period is implemented).

C. Special Tax on Small Businesses below Threshold

Although a registration threshold is very beneficial from the perspective of facilitating the administration of the VAT, it has two drawbacks.

- First, it gives small businesses just below the threshold a price advantage over competing businesses that are just over the threshold and who must register and charge VAT. (This is only an advantage for businesses that sell predominantly to final consumers. It is in fact a disadvantage for a business that sells to registered VAT businesses not to be registered for VAT.)

- Second, small businesses just under the threshold may underreport their sales in order to stay below the threshold.

One way to reduce the above competitive advantage and the disincentive to cross the threshold is to apply a flat tax rate to the gross sales of businesses below the threshold. The following design is proposed for this tax :

- Tax rate of 2% on gross sales. (The Korean IPF suggested a rate of 3%, which would be equivalent to a 15% VAT if value added is 20% of the sale price. I believe this is too high. The Korean IPF paper indicated that based on IMF data, the value added for small businesses is 15.86% of the sale price[3], implying that a neutral flat rate would be about 2.4% of gross revenues. The intention is to set a rate that would collect somewhat less tax than would be collected if the small business were registered for VAT – and thereby act as a middle step between being unregistered and registered.)

[3] Korea Knowledge Partnership Project, p. 12

- It is not necessary to impose this tax on *all* small traders below the threshold. Rather it should be imposed on small traders above a specified intermediate threshold, such as 5,000,000 Tgs. The objective is not to tax very small businesses more; rather it is to lessen the difference between registered businesses just over the threshold, and unregistered businesses just under the threshold.

- It could be collected using the same collection mechanism for collecting Enterprise Income Tax from corporations and unincorporated businesses (i.e., individual proprietors). Presumably, for many small businesses, the gross sales would have to be estimated.

- It would cease to be payable if the small business registers for VAT, either because it crosses the threshold, or because it voluntarily registers.

- It would not be payable by small businesses that are predominantly in exempt sectors identified in Article 9 (particularly, small herdsman, farmers, doctors, etc.).

Based on Enterprise Income Tax data for 2002, there were 2525 legal persons with sales revenues between 5-10 million Tgs who in total had sales of 19,349,691,000 Tgs (average sales 7,663,000 Tgs). Consequently, if all this revenue were subject to the 2% tax, it would result in tax revenue of 386 million Tgs. To this should be added the tax amount collected from individual proprietors that earn such business income.

Recommendation
The GDNT should consider applying a tax, as described above, to unregistered VAT small businesses with sales between 5 million and 10 million Tgs.

D. Registration Transitional Arrangements

Inventories and Capital Held at time of Registration

As discussed above, large businesses in the start-up phase will typically wish to be registered from the very outset prior to incurring any expenses. However, there will be many small businesses that will be under the threshold for some time, and gradually will increase in size until they cross the 10 million threshold and are required to register.

The question is whether the VAT Law should provide such newly registered small businesses a credit for the VAT cost they incurred on purchases prior to being registered of capital equipment and inventories that they still hold at the time they register.

Generally, VATs do not provide newly registered businesses a credit for VAT incurred prior to registration.

Canada provides a credit for small businesses that become registered (either voluntarily or when they cross the threshold) equal to the VAT paid on inventories held at the time of registration, and on the fair market value of the capital equipment they own at the time of registration. For example, if a small business paid $1,000, plus $100 VAT for a

computer one year prior to registration, and at the time of registration the fair market value of the computer was $500, it would be allowed a credit upon registration of $50.

In addition, the Canadian VAT also allows a newly registered business to claim a credit for any GST that it prepaid on rent or services (e.g., utilities) that relate to the period after registration. For example, if in July a business prepaid rent (plus VAT) until the end of December, and it registered for VAT on September 1, it would be entitled to an input credit for the VAT it had paid relating to the period from September 1 until December 31.

The above treatment gives the correct conceptual result. However, if it is applied rigorously through physical inspections of inventory and capital, it would require significant effort by the administration system, particularly given that in Mongolia, the large (17%) growth in the registrant population each year.

However, there is an additional complication in Mongolia, to the extent that there are some start-up businesses that have been denied registration, and consequently, have incurred substantial VAT on their inventories and capital. These businesses will be faced with double taxation of their sales once they start paying VAT on their sales.

Recommendation

As a general rule, it is not advisable for Mongolia to provide any credits for capital and inventory held at the time of registration of a new business.

However, the GDNT should consider a special transitional provision whereby start-up businesses that have up to now not been permitted to register should be allowed to register and claim a credit for their capital and inventory purchases incurred during the past 6 months. This rule would apply for large start-up businesses and for newly registered small businesses.

However, this would be a transitional rule only. It would apply for a period of say, 6 months, during which time all businesses in the start-up phase would be permitted to register. It would then be terminated.

Businesses would then have the option of registering voluntarily in order to claim input credits for purchases. However, if they choose not to do so, at the time of registration, they would not be given a credit for VAT paid prior to registration.

E. Group Registration

Where there is a group of associated taxpayers, the registration threshold should apply to the sum of the turnover of the group, rather than each member. This is to prevent an otherwise registerable business from splitting into several separate companies in order for each to stay under the threshold.

Some countries allow group registration for a group of closely related businesses. That is, where there is a group of businesses with substantially common ownership, a single entity can be chosen to register on behalf of all the businesses. It must treat all purchases

from outside the group by any member as its own purchases, and it must treat all sales by any member of the group, outside the group as its own sales. Sales between members of the group are ignored.

This approach can reduce compliance and administrative costs. However, to the extent that different legal entities would be making purchases, for which the VAT credit would be claimed by another company, it may be more complex for the tax authorities to track sales and purchases. In particular, it may present an opportunity for inappropriate tax planning if one of the members makes exempt sales and is therefore not able to claim full input credits – i.e., it may try to shift its purchases to taxable members of the group.

Recommendation

The GDNT should consider allowing such group registration, such as is done in New Zealand. However, it should permit group registrations only where all members of the group are fully taxable on their sales (i.e., no financial institutions or other exempt entity).

F. Deregistration

Mandatory Deregistration of a Taxpayer by the Tax Office

Article 4.8 of the VAT Law provides that a business shall be deregistered if its sales fall below 10 million Tgs for the past year, and this is expected for the subsequent year also. This may result in some businesses being required to deregister, and then re-registering some time later. This would entail much disruption for the business. Also, this Article seems to conflict with the intent of Article 4.4 which provides that any business that is carrying on a taxable business activity can register voluntarily, even if its sales are under the threshold (i.e., would a voluntary registrant whose sales are under the threshold be required to deregister under this provision?)

Recommendation

The GDNT should consider modifying Article 4.8 so that it applies only if a business ceases all taxable activity and does not intend to recommence taxable business activity within a reasonable time frame (e.g., 6 months).

Voluntary Deregistration by the Taxpayer

VATs generally discourage businesses from flipping back and forth between registered and unregistered status (e.g., in order to obtain input credits for large one-time purchases). A minimum time period to be registered is beneficial in this regard.

Recommendation

A registered business is permitted to deregister voluntarily only if its sales (and those of its associated companies) for the past 12 months fall below the 10 million Tgs threshold and it has been registered for at least one year.

Charging VAT upon Deregistration

As contemplated in Article 5.2.2, where a business deregisters from VAT, it should be required to pay VAT on the fair market value of all taxable assets (inventory and capital) for which it has previously claimed input tax credits. This provision is very appropriate.

4. Refund for Consular Offices and Diplomats

A. Current VAT Law Treatment

Article 9.2.2 exempts imports for use of diplomatic missions or international organizations in Mongolia, covering both official use, and personal use goods.

Article 9.2.3 exempts goods and services purchased locally by the diplomatic missions and consular offices, provided that:

a) the purchases are for the official use of the organization (not personal use); and
b) there is reciprocal treatment of Mongolian consulate in the foreign country.

Article 9.4 specifies that the exemption in Article 9.2.3 is to be applied by means of a reimbursement to the diplomatic mission or consular office, rather than point of sale relief.

B. Assessment

Most VATs provide relief for foreign diplomats and consulates located in the country. Imports are straightforward to deal with – Customs administers an exemption for all goods imported by the particular consulate.

Regarding local purchases, some countries provide a point of sale exemption for purchases by diplomats and consular offices. In such situations, the official staff of the consular office are given exemption certificates which they show to the vendor in order to obtain relief. The problem with this approach is that it is more difficult for vendors to comply with and document to the satisfaction of the tax authorities, and it is more difficult for the tax authorities to monitor.

Consequently, Mongolia is one of many countries (e.g., Canada) that use the refund mechanism to relieve foreign diplomats and consular offices from VAT on their local purchases.

Based on my discussions with the Large Taxpayer Office, which is responsible for the administration of the refund program, the refund program is operating quite smoothly.

It should be noted though, that in my discussion with one taxpayer that makes supplies to embassies in Mongolia, they were not aware that they were required to charge VAT on their sales to embassies. They apparently had been audited regularly and their

exemption of their sales to embassies had always been accepted. It appears that the change to the refund mechanism, in June 2001, may not have been widely publicized to taxpayers, nor perhaps to tax auditors.

One policy issue is whether the refund should apply to personal-use purchases as well as office-use purchases.

International practice is mixed but most VATs (e.g., Canada) provide some relief for personal-use purchases.

Recommendation

There is no a compelling reason to broaden the refund provision to include personal use purchases. However, if for international reasons it is decided to extend the refund in this fashion, the following treatment is recommended:

- The refund should only be made to persons that have official diplomatic status (i.e., that have been issued a diplomatic identity card and number).

- To reduce administrative problems, a single refund claim should be submitted by the consular office, and it should separately list the official purchases made by the consular office, and the personal-use purchases made by each consular staff member, showing their name and diplomatic identity card number.

- The refund claim should include copies of all invoices for which refund of VAT is being requested.

- To avoid consular officials including many small purchases on their refund claims, the government might consider limiting the refund claim to individual invoices the value of which is over a certain threshold (e.g. 10,000 Tgs.)

5. VAT Exemptions

A. Exemption for Residential Rent

Article 9.1.2 exempts residential rent. This is common in many VAT jurisdictions. However, under Article 11.3.4, there is no denial of the input credits for a residential property owner that is able to be VAT registered. This is peculiar in that it effectively allows VAT to be recovered on expenses such as electricity, where they are included in the rent. The VAT on these expenses would not be recoverable if paid directly by the tenant.

Recommendation

Continue the exemption, but deny input credits for expenses by the landlord.

B. Exemptions for Educational Services/ Medical Services

The VAT Law exempts educational services and medical services. These are common exemptions in VAT jurisdictions. However, they are prone to many debates over the borderline between taxable and exempt services. For example, should driver training for automobiles be considered as an exempt educational service.

Apart from such borderline issues, it is understood that entities such as hospitals and educational institutions also provide other business activities, which normally would be taxable –e.g., cafeteria services, drug stores, parking lots. It is unclear if these are actually operated by the institution, or whether it simply rents out the space to other businesses (that are registered).

It is desirable to avoid requiring the institution to register and have to pro-rate inputs between taxable and exempt activities. However, to the extent that the institution is operating such businesses itself, it should be required to follow the regular rules, register and remit tax on its operations.

Recommendations

The GDNT should consider limiting the exemption for educational services to formal education situations – e.g., courses offered by schools, universities. Courses by non-accredited educational institutions (e.g., driving instruction schools) should be taxable in the normal manner.

Where a medical or educational institution operates a taxable business (e.g., drug store, cafeteria) on its premises, it should be required to register and be taxable on these activities. In this case, it will have to pro-rate its inputs between the taxable and exempt activities (as discussed in Item H below).

The GDNT should consider exempting space rent charges by educational institutions or hospitals. This will allow such an institution to rent out space to other businesses without requiring the institution to register or pro-rate input credits relating to its space rentals. There is no loss of revenue, as the lessee would otherwise be entitled to an input credit.

C. Exemption for ODA Projects

Where a foreign aid organization (e.g., JICA) provides ODA funds for a particular contract, there is generally a stipulation that the funds provided will not be used to pay local taxes. The objective is to ensure that the entire amount goes toward the intended project, and is not diminished by the application of taxes on the materials used in the project.

Typically, the project contractor will be a non-VAT registered foreign contractor, who will import equipment and other goods as well as purchase goods and services from local suppliers.

Current VAT Treatment

Article 9.2.4 exempts "Humanitarian and grant aid goods obtained from governments and non-governmental organizations of foreign countries, international charity organizations". This term is defined in Article 3.1.10 to include both imports of goods in respect of the project, and purchases of goods and services in Mongolia using funds for the project.

VAT registered businesses selling goods and services to the project contractor do not charge VAT on their sales. Special invoices are provided to the project contractor, which the project contractor issues to the supplier (i.e., purchaser invoices).

The supplier is not denied claiming input tax credits in respect of its supplies to the contractor so, in effect, the sales to the project contractor are zero-rated, not exempt.

The contractor provides one copy of the special invoice to the supplier, it retains one copy for its books and records, and it sends one copy to the GDNT.

The government specifies which projects are to qualify for the special invoices.

Assessment

The current system appears to be functioning acceptably, but it is very complex administratively, requiring a special form of invoices to be distributed to all project contractors for their local purchases. As the number of ODA projects increases, this mechanism will become increasingly difficult to administer.

Alternative Approach

The most straightforward approach would be for the GDNT/ Ministry of Finance, the Ministry of Industry, and the international donors to agree on the following arrangement:

Imports

- The Ministry of Industry and the donor agree on a list of imported goods over the term of the project.
- The list would be provided to the project contractor and to Customs. The goods on this list would be exempt when imported.
- Alternatively, the GDNT could calculate the amount of tax on the imports and would give special vouchers to the project contractor to pay Customs the VAT (and import duties) on the imports. The benefit of this approach is that there would be no potential administrative delays with Customs having to verify whether particular imports were on the list.

Local Purchases

- A streamlined refund system would be put in place for the VAT for these local purchases. At the start of the project, the Ministry of Industry and the donor would agree on a list of local purchases, month by month, required for the project. This would be submitted to the GDNT.
- Based on the list, the GDNT would determine an estimate of the VAT payable for each month, as well as the cumulative VAT payable over the project.
- The project contractor would pay VAT to its suppliers and would receive normal VAT invoices from them. Each month the project coordinator would accumulate its invoices and submit a refund application form to the GDNT.
- The GDNT would verify the VAT refund amount from the VAT invoices provided and would process the refund request for payment on a priority basis.
- Provided the refund claim were reasonably close to the monthly estimate based the agreed list, and the cumulative refund threshold had not been passed, the refund would be paid without more than an arithmetical verification.
- Refund amounts over the monthly threshold would be subject to a pre-payment desk audit (in which the tax office may contact the project coordinator or a supplier for confirmation of any unusual amounts). However, monthly payments would still be processed without significant delay.
- In each case, there would be a subsequent review to confirm that the actual purchase items match the items on the proposed list of purchases agreed between the donor and the Ministry of Industry.
- The success of this approach will depend on the ability of the Mongolian authorities to convince donors that refunds will be paid promptly and to do this in practice.

Streamlined "Advance Refund System for VAT on Local Purchases

- If donors are not persuaded by the above system, a streamlined "advance refund system" could be implemented for ODA projects.
- Under this system, based on the month-by-month schedule of local purchases (and the associated VAT), an advance payment for the estimated VAT would be paid to the contractor each month on say the 15th of the month. Each month, the project contractor would submit a claim for the actual purchases made during the month (say on the 10th of the month following). To the extent that there was a difference between the advance payment (based on the monthly estimate) and the claim for actual VAT paid by the project, the difference would be added or subtracted to the next month's advance payment.
- By such a method of advance payments, the GDNT should be able to assure donors that the project contractor will not be out of pocket the VAT on local purchases.

Recommendation

The GDNT should discuss with the Ministry of Industry and project contractors the implementation of either of the above systems. If it is not possible to implement for existing projects, consider implementation for new projects.

D. Exemption for Heavy Equipment for Priority Industries

The VAT Law exempts a list of imports and local purchases of specified types of heavy equipment for specified priority industries and exporters. Local suppliers of such equipment are entitled to claim input credits. Consequently, in effect such equipment is zero rated by this provision. The purpose of this exemption is to facilitate such industries acquiring these inputs without VAT.

This provision is useful in the current environment where refunds are not being paid regularly as it limits the amount of VAT that these businesses incur. However, the exemption is problematic as it is available only to selected industries, prompting pressure to expand the list. It also applies only to a list of selected equipment, prompting pressure for more items to be added to the list. Also, confusion can result as to whether certain items qualify or not.

This provision would not be needed if the refund policies and procedures set out in Section 2 were implemented.

> Recommendation
> If refund policies and procedures in Section 1 are implemented, and if the exemption for gold (see item F below) is repealed, the GDNT should consider repealing this provision.

E. Exemption for Agricultural Producers

Various approaches have been taken by VAT jurisdictions to deal with agriculture and other primary products sectors. Some countries, such as New Zealand treat farmers the same as all other businesses – they are required to register (if over the small traders threshold) and they must charge VAT at the standard rate on their sales. Canada zero rates most sales by farmers and fishermen, and consequently they are in a perpetual VAT refund position. Either zero rating or taxing farmers and other primary producers requires that these persons have reasonably sophisticated bookkeeping for their operations and are relatively small in number compared to the total VAT taxpayer base.

Most countries (particularly developing countries and countries in transition) try to exclude the primary sectors from the VAT system. In Mongolia, Article 9.2.9 exempts sales "primary raw materials produced in the territory of Mongolia from agriculture, forestry, and hunting" where the sale is by the primary producer. Consequently, farmers and other primary producers do not register for VAT in Mongolia. This policy is quite appropriate – it significantly reduces the burden on the VAT administration system.

Problem with Exemption

While this treatment is an effective way of reducing the administrative burden, it does result in a problem for the primary producers in that their costs are increased by the VAT on their inputs, such as gasoline, electricity, etc.

Discussions with tax officials and industry representatives (flour) note that prices charged by Mongolian producers (of wheat, for example) are not competitive with those of imports.

It is not clear to what degree any uncompetitive prices are the result of the VAT on producer inputs. Presumably, there are other factors contributing to this – i.e., subsidies to foreign suppliers, cheaper production conditions. The question of whether a Mongolian farm subsidy program or an increase in Customs import duties is desirable or not is beyond the scope of this paper.

However, to the extent that the exemption does result in higher costs to the producer, there are two approaches one can consider to reduce the burden: (1) a flat rate addition/ notional input credit scheme used in some countries, or (2) providing credits for VAT paid on inputs to agricultural producers. These are discussed below.

(1) Flat Rate Addition/ Notional Credit Mechanism

It has been suggested that it may be desirable to provide a "notional credit" to domestic processors for their purchases of primary products directly from producers.

Under this scheme, the primary producer would still not register, nor claim any VAT back from the government. Rather, when it sells to a processor in Mongolia, the processor would issue a "purchase invoice" to the producer, and retain a copy for its own records. The invoice would specify (1) the net purchase price, (2) a flat rate addition to the price (the percentage which would be set in regulations) and (3) the total price paid to the producer including the flat rate addition.

The processor would then be able to claim a "notional input VAT credit" on its VAT return, equal to the flat rate additional amount paid to the farmer.

Advantages

This intention of this mechanism is to compensate the primary producer an amount to offset the unrecoverable VAT it pays on its inputs (e.g. feed, gasoline). This mechanism is relatively simple, and it keeps the primary producer out of the VAT system.

Disadvantages

The notional credit approach is definitely "rough justice". For example, if a rate of 5% is set, this might be appropriate for some, generous for others, and too little for others. In addition, it is difficult to assess whether the benefit of the credit would accrue to the producer or the processor.

Application of notional credit to exporters

The question arises whether such a notional credit should be given to purchasers who resell the product in the export market. If the credit merely offsets the cost of the VAT

on inputs to the farmer, conceptually there would be no reason to deny the credit to a purchaser/exporter. However, given the potential of this method to overcompensate for the VAT paid on inputs, it is reasonable to limit the credit to sales to local processors, rather than provide it to purchaser/exporters for direct export.

(2) Credit Directly to Producer

Rather than use the above flat rate mechanism, a more accurate way to compensate the producer for the VAT on inputs would be to allow the producer to claim a credit for the actual amount of VAT it pays. Various mechanisms to achieve this were considered (i.e., using processors to reimburse producers for actual VAT paid by producers to their suppliers). However, the most reasonable method would be for the producer to accumulate the VAT invoices it receives from its suppliers and to receive a credit for the VAT paid directly from the tax office against income tax otherwise payable to the tax office.

Recommendation
The GDNT should consider giving agricultural producers a credit equal to the VAT paid on their purchases against their income tax otherwise payable. For agricultural producers with no income tax payable, the tax office would provide them a refund for the VAT paid.

F. Exemption for Gold Sales

The treatment of gold sales under the Mongolian VAT has undergone much change since the VAT was introduced. The following is a brief summary of the chronology of changes to the tax rules facing this industry.

July 1998

- Initially, gold sales were taxable at 10% (the standard VAT rate) when sold domestically and zero rated when exported, i.e., they were treated like all other goods.
- That said, under other Mongolian laws at the time, gold producers were not permitted to sell to anyone other than the Mongol Central Bank. Consequently, the fact that gold exports were zero-rated was not relevant.
- Sales to the Central Bank were set at the world price, inclusive of VAT. Consequently, gold producers absorbed the VAT on the sale.
- Royalty rate was 2.5% for hard rock and placer gold.

August 1998

- When the VAT rate was increased to 13% in August 1998, the gold industry complained that the additional 3% burden (which they were absorbing) was too high.

November 1998

- In November 1998, the tax rate on gold was reset at 10%. At this time, gold suppliers were permitted to export. However, when the rate was lowered to 10%,

the tax rate on exports of gold was also set at 10%. Consequently, the price paid to gold producers remained at the world price, inclusive of 10% VAT.

- Throughout this time, gold producers were able to claim VAT input credits for VAT paid on their costs, and were carrying forward large balances of excess credits, which offset any VAT payable on their sales of gold.
- The Royalty tax rate through this time had been 2.5% of sale price, both for placer gold and hard rock gold.

December 2001- Present

- Gold sales were made exempt. Consequently, since this change, gold producers have not had to charge VAT on their sales, but they have not been able to claim input credits for their input VAT.
- At the time the exemption was introduced, the Royalty tax rate on placer gold was raised from 2.5% to 7.5%.

Assessment

The intent of all these changes to the VAT Law and Royalty tax rate appears to be to obtain an appropriate fiscal return from gold producers in Mongolia.
This report does not question the right of the Government of Mongolia to receive a revenue stream from the mining of minerals in Mongolia. However, the use of a VAT exemption to partly obtain this revenue stream (i.e., through the denial of input credits) causes a serious flaw in the operation of the VAT. In addition, given the lack of transparency of this mechanism to obtain revenues, it is very difficult for the authorities to know how much revenue they receive from this source, or to predict the revenue stream from future mining and production of gold.

Problems created for VAT due to Exemption

The exemption for VAT creates several problems for the operation of the VAT:

(1) Competitive inequities between mining companies
- The effect of the exemption varies substantially between competing mining companies.
- For example, for a company that has relatively low input costs, the VAT cost will accordingly be quite low); a high-cost mining company will incur more unrecoverable VAT on inputs.

(2) Incentive to structure operations to recover more input tax credits
- Companies will have an incentive to restructure their operations to try to recover more input credits .
- For example, they will have an incentive to use exempt supplies (i.e., the will try to import and purchase items that are exempt under Article 9.2.10). Also, to the extent that they also engage in other activities that are taxable (e.g., copper mining), they will be able to recover more input credits.

(3) Potential increase in non-compliance

- To the extent that businesses cannot claim input credits for VAT on inputs, the VAT on purchases represents a real cost to the business. Consequently, businesses will be more inclined to push suppliers to make sales to them without VAT invoices, eroding both VAT and EIT revenues to the government .

(4) Complexity for taxpayers and tax authorities

- To the extent that businesses may have both gold mining (exempt) and other mining (taxable) activities, they would be required to apportion inputs to each activity. Input credits would be available to the extent that the input is used in the taxable activity.
- In addition, problems arise when the gold mining company sells equipment used in gold mining. For example, do they charge VAT on the sale of a truck, that was used in the gold mining activity and for which they could not claim an input credit? What if they used the truck for both gold and copper mining and claimed a partial credit?

Other Problems of Exemption

Apart from the problems created for the operation of the VAT, the exemption may result in other problems for the government. In particular, to the extent that the reason for the VAT exemption is to generate additional revenue for the government (i.e. from the denial of input credits), this will be an uncertain revenue stream, which could diminish to the extent that companies are able to find ways either to decrease VAT paid on inputs or to increase the amount of input credits they can claim.

In addition, it seems that any such tax on mining should be lower for companies that contribute more to the development of the Mongolian mining sector, and higher for companies that merely exploit known and easy-to-mine mineral reserves. However, the VAT exemption achieves exactly the opposite effect – the more that a mining company puts into developing the resource (e.g., exploration), the more unrecoverable VAT it will incur. Conversely, a company that merely exploits a known reserve with gold deposits close to the surface will bear much less unrecoverable input VAT.

Recommendations

For the above reasons, the GDNT should consider repealing the exemption and taxing gold sales in the normal manner – i.e., taxable if sold domestically, zero-rated if exported.

However, it is proposed that sales of pure gold (above a specified purity level) to the Mongol Central Bank be zero-rated. The gold purchased by them becomes a financial instrument. Subsequent sales of the gold (as a financial instrument) would be exempt. (This approach is used in other VAT jurisdictions).

Ministry of Industry should (in consultation with the mining industry) determine a satisfactory royalty tax rate (consistent with international norms and the specific circumstances in Mongolia) to generate mutually acceptable revenues to Mongolian government from this resource.

Transition Issue

If gold sales are made taxable (or zero-rated) as described above, there is an issue as to whether companies should be permitted to claim input credits for VAT incurred for past periods.

This is a very complex issue. Conceptually, under the principles of the VAT, it would seem that in this scenario, taxpayers should be entitled to an input credit equal to the VAT incurred on capital expenditures, adjusted to take into consideration the current fair market value of the capital property.

For example, if a mining company imported a truck in 2002 for 50 million Tgs and paid 7.5 million Tgs of VAT to Customs, and the fair market value of the truck was 40 million Tgs at the time gold mining became taxable, the mining company should be entitled to an input tax credit when gold becomes taxable equal to:

$$7.5 \text{ million Tgs} \times \frac{40 \text{ million (Fair Market Value)}}{50 \text{ million (original value)}} = 6 \text{ million Tgs}$$

However, as a practical matter, this would be difficult to do for all mining equipment. In addition, the formula would be complicated if the mining company had claimed input credits for equipment used partially in a taxable activity.

On balance, perhaps the simplest approach would be to agree to allow companies to claim a credit for a fixed percentage (e.g., 80%) of the outstanding balance of input VAT paid.

This issue should be considered as part of any consultations regarding a new Royalty rate structure (if this is needed).

G. Exemption for Tour Operators

Article 9.1.13 exempts services by tour operators providing tours to foreign tourists. Tour agents that make supplies to the tour operator (e.g., local camps, hotels, restaurants, air traveletc) charge VAT to the tour operator on their taxable supplies, and this is non-creditable to it (under 11.3.4).

The net effect of the above is to make the tour operator's margin non-taxable. Note also, that to the extent that the tour package includes zero rated elements (international air travel), under this scheme no tax applies on the international air travel. Tax only applies on the taxable domestic services that are sold to the interpretation.

The purpose of the exemption is to make Mongolia a more attractive tourist destination for foreign tourists.

Potential Problems with Exemption

To the extent that some tour operators also have their own hotels and provide their own tourism services, they are at a significant competitive advantage versus other hotels and tourism providers (tour agents).

Consequently, independent tour agents are pressing the government to be classified as tour operators.

The inequality is particularly problematic if tourists in Mongolia have the choice between tour operators (non-taxable) and tour agents (taxable).

Recommendation
Limit the tour operator exemption to tours purchased and paid for outside Mongolia (e.g., sales of Mongolian tour packages sold by agents in Japan).

H. Rules for Allocating Inputs between Exempt and Taxable Activities

Under VAT, businesses are entitled to claim input credits for VAT paid on inputs used in VAT-taxable activities. They are generally not entitled to claim input credits for VAT paid on inputs used in exempt activities.

The question arises as to what input tax credits should be claimable where a business is involved in both taxable and exempt activities.

Mongolian VAT Treatment

Administratively, the GDNT uses a revenue based allocation formula. Under the revenue based allocation formula, the input tax credit (ITC) is equal to:

$$\text{ITC} = \text{Total input VAT paid} \times \frac{\text{Taxable Revenue}}{\text{Total Revenue (taxable plus exempt)}}$$

Assessment of Revenue Based Allocation Formula Method

Although it is apparently simple and reasonable, the Revenue Based Allocation Formula Method may yield inappropriate results in many situations. The following are some potential problems with this method.

1. No Revenue from Exempt Activity – For example, if a religious charity undertakes an exempt activity (providing free counselling to poor) and a taxable activity (cafeteria), and it raises no money from its exempt activity, this formula would suggest that it can claim full input credits

2. Tax Planning Opportunities – An otherwise exempt business (e.g., bank) can merge with a business (e.g., consulting firm) that has high revenues but low inputs. This will allow the bank to claim significantly more input credits than otherwise.

3. Definitional Issues – For example, in determining the amounts for the revenue-based method, questions arise whether one should one look at net revenues or gross revenues. Gross revenues are simpler, but may not represent the true contribution of that activity to the business.

Other Allocation Methods

In many countries, the following 3-step allocation method is used.

Step 1: Single Use Inputs – Directly attribute to a particular activity any inputs that are used exclusively in that particular activity.

Step 2: Multi-Use Inputs – Allocate multi-use inputs that can be to some extent identified with the particular activities (for example, rent may be allocated between taxable and exempt activities based on the floor space used by each activity).

Step 3: Non-attributable inputs – Allocate residual inputs (inputs that cannot be directly identified with a particular activity) using a formula method – either revenue-based (i.e. based on the revenues of the taxable versus exempt activities) or input-based (based on the percentage allocation of the other inputs using steps 1 and 2).

For example, consider the situation where a bank owns an 6 floor office building, which it uses 2 floors for its banking activities, and it rents out the remaining 4 floors as offices.

Its revenue from the two activities are as follows:

Banking (exempt)	200 million Tgs
Office rentals (taxable)	100 million Tgs
Total	300 million Tgs.

It incurs the following expenses:

			VAT
1)	Electricity	10	1.5
2)	Data processing (bank)	40	6.0
3)	Printing (bank)	40	6.0
4)	Cleaning (offices)	10	1.5
	Total	100	15.0 million

Revenue-based allocation

ITC = 15 x $\frac{100}{}$ = 5 million

300

Multi-Step Method

ITC = 1.5 (cleaning) + 1 (electricity – based on 4/6 floors) = 2.5 million

Recommendation

GDNT should consider using multi-step approach in allocating inputs between exempt and taxable activities.

6. Non-Deductible Input VAT for Automobiles

Article 11.3.1 of the VAT Law states that input tax credits are not permitted for acquisitions of automobiles, and parts therefor. The denial of input credits for automobiles is reasonable, given that many automobiles are used significantly for the personal use of the owners or employees. Denying an input credit up front avoids the necessity of having to pro-rate the value of the automobile between the business use and the personal use components.

However, the current provision also denies input credits for automobiles that are purchased for resale, or lease. This is problematic as it results in double taxation of the vehicle. For example, where an automobile dealer imports automobiles to sell in Mongolia, it pays tax to Customs on the import of the vehicle, and then charges VAT on the sale (or lease) of the vehicle in Mongolia. Denying an input credit to the dealer results in tax applying on top of unrecoverable tax paid to Customs.

Automobiles of Taxi Companies

The current practice is for taxi companies to import vehicles, and then charge individual taxi drivers a daily fee for them. Through this daily fee, the driver eventually owns the vehicle. Currently, the taxi company pays VAT to Customs on the import for which it cannot claim an input credit, and it does not charge VAT on the daily fee charged to the driver.

Conceptually, under a VAT, the taxi company should be able to recover the VAT it pays to Customs and then it should charge VAT on the daily fees charged to drivers. This would ensure that the taxi company's margin is brought into the base for the VAT. However, simply implementing such a system without any transitional provisions would result in substantial double taxation of all existing vehicles, and would likely impose a significant financial hardship on taxi drivers who might well see their fees rise by 15%. A transitional rule could be implemented where the new regime applied only to automobiles acquired after the date of the tax change – i.e., for these vehicles, input credits should be given to the taxi company and it would have to charge VAT on the daily fee for these vehicles; for vehicles acquired prior to the tax change, the old rules would continue to apply.

Recommendations

Automobile dealers should be entitled to input credits for their acquisitions of vehicles.
Taxi companies should be entitled to input credits for their acquisitions of vehicles and should charge VAT on the daily payments charged taxi drivers. However, as a transitional rule, the present system regime should continue to apply to daily payments for existing automobiles.

7. Treatment of International Telecommunications

During the assignment, questions were raised regarding the proper VAT treatment of international telecommunications. Specifically, where a person makes a telephone call from Mongolia to a person located in a foreign country, VAT applies on the telephone call. However, because of lower foreign rates, generally the call originates in the foreign country and terminates in Mongolia. In these cases, no Mongolian VAT applies to the call. It was noted that in these cases, there is an element of consumption in Mongolia that should be taxed.

Assessment

It is correct that there is an element of consumption at both the origin and the termination points of an international phone call or other form of telecommunications service. Consequently, while there is an element of consumption in Mongolia in the case of an incoming call, so too there is an element of foreign (exported) consumption in the case of an outgoing call. Recognizing this, most VAT jurisdictions determine the tax status for international phone calls based on where the phone service is billed. Consequently, an outgoing phone call billed in Mongolia will be subject to Mongolian VAT. An incoming call from a foreign country, which is billed in the foreign country, will be subject to that country's sales tax or VAT.

This avoids tax being applied twice on the same telecommunications service (i.e., by both the country of origin and the country of termination). In addition, this recognizes the fact that only the country where the phone call is billed will have the data to apply the VAT. For example, if a call to Mongolia originates in France, and is billed to the person in France by the French telephone company, Mongolia has no data or price on which it can levy the Mongolian VAT.

Note that this situation can be differentiated from the lease of a dedicated telecommunications line. For example, consider the situation where the Mongolian telecommunications company charges a Chinese company for a dedicated line connecting a company in Ulaan Baator, with a parent company located in China. The charge for the Mongolian portion of the dedicated line should be subject to VAT as it relates to real property located in Mongolia.

8. Treatment of Gifts, Promotional Goods and Samples

There are a number of situations where a business will "give" away goods in order to promote its products or business. For example, a business may give away promotional T-shirts, pens, etc., bearing the logo of the business to prospective customers.

Under the Mongolian VAT, Article 5.2.3 indicates that any transfer of goods for which an input credit has been claimed is considered a "sale" for VAT purposes, and under Article 7.3, the value for tax of these goods is equal to the market price.

Some VAT jurisdictions (e.g., Canada) do not impose tax on free goods, except where the gift is on a non-arm's length basis (e.g., a gift to a relative).

However, most VAT jurisdictions apply tax on the value of gifts over a specified value. The application of VAT in Mongolia to such gifts is consistent with this international practice.

It is not clear whether the Mongolian VAT also applies to businesses' distributions of samples. Generally VAT does not apply to a business' give-aways of samples of its own product, in forms not commonly sold, to promote its products (e.g., small samples of shampoo or household cleaners). The taxpayer is entitled to claim input tax credits for the production of such samples and no tax is payable on the free distributions.

It is also not clear how the Mongolian VAT applies where a business gives away a free item of inventory to a customer that is buying another item (e.g., buy two for price of one). In these situations, the VAT should apply to the price paid. This is effectively the same as a 50% off sale and should be treated as such.

Recommendation

The GDNT should review its treatment of free promotional goods. In particular, it should consider not applying VAT on samples given away, and it should not apply VAT to any item given away as part of a "buy one, get one free" pricing policy.

9. Penalties

Article 13 of the VAT Law imposes penalties in the following two situations. First, under Article 13.1, where a business has passed the 10 million Tgs threshold and but has not registered for VAT as required, it is subject to a penalty equal to 8% of the value of VAT taxable sales during the period. This amount is to approximate the tax that would otherwise have been remitted. (Implicitly, it assumes that the ratio of value added to taxable sales for the business is approximately 8:15).

Article 13.2 addresses the situation where a person that is not registered fraudulently issues an invoice charging VAT, and does not remit this VAT to the government. In this case, the person is subject to an interest penalty equal to 1% per day of the amount fraudulently collected as VAT.

Assessment

The penalty regime used by the GDNT is not structured in a way to be effective. Consultants (e.g., JICA, Arthur Mann from DAI) have previously commented that the penalty system for taxes is inflexible generally and needs to be restructured, and the advice here for VAT is the same. Most penalty regimes for VAT employ a penalty structure consisting of the following types of penalty charges:

(1) a fixed value administrative penalty for each non-compliant action (e.g., late filing), which applies even where the taxpayer does not owe any taxes. For example, this would apply in the case of a late-filed return even where the taxpayer is in an excess credit position. This is generally not too much for the first offence, but it should increase with each non-compliant action, and be sufficient to ensure that the taxpayer takes its compliance responsibilities seriously;
(2) a penalty expressed as an interest rate (e.g., 6% in Canada) which is added to the market interest rate charge outlined in (4) below. This is applied where there is no serious fraud at issue, but VAT has incorrectly not been applied or remitted on sales, over input tax credits have been incorrectly claimed;
(3) a penalty amount expressed as a percentage of the tax owing (e.g. 25% -100% of tax). Such penalties apply to more serious infractions, such as collecting VAT while not registered. This penalty applies to the amount of tax owing, and is chargeable in full immediately – it is not time dependent. The penalty rate can vary depending on whether the taxpayer is a repeat offender. For cases involving outright fraud (e.g., counterfeiting invoices), criminal charges may also be laid;
(4) an interest component, which should be tied to the prevailing market lending rate and adjusted regularly (e.g., each calendar quarter) which is applied to the amount of net tax owing. It is intended to compensate the government for not having received the tax amount payable on time. To ensure that the government does not become the "lender of choice" to taxpayers, the interest rate charged on overdue amounts should be a few percentage points above the normal lending rate of the banks. This interest rate should be applied in addition to the other penalties.

Article 13.1 and 13.2 Penalties

The "penalty" imposed by Article 13.1 is too light for a reasonably serious offence as not registering. In addition, the "effective" penalty varies substantially depending on the circumstances of the taxpayer.

- Consider the situation of a service business, for example, that does not register when it passes the threshold. During the period while it is non-compliant, it has sales of 1 million Tgs, and taxable purchases of 200 thousand Tgs. If it had been compliant and had registered, it would have remitted 120 thousand Tgs of VAT. However, under Article 13.1, it is subject to a penalty of 80 thousand Tgs.

- A goods vendor in the same situation, but with taxable purchases of 800 thousand (i.e., markup of 25%) would, if registered, have remitted 30 thousand Tgs, but under Article 13.1, it will be subject to a penalty of 80 thousand Tgs.

In short, for some businesses, the penalty imposed by Article 13.1 is quite substantial, while for other businesses, it may result in a significant savings compared to what it would have paid if it had been compliant.

With regard to the penalty imposed by Article 13.2, this is clearly a more egregious violation and should be subject to a very substantial penalty. However, the amount of penalty imposed under 13.2 will depend mostly on how much time has passed between the time the violation occurs and the time the person is caught. Indeed, if the person's fraud is identified quickly, the penalty will be quite modest.

A preferred approach is to require the person to remit an amount equal to the tax that should have been remitted, add to that amount a flat percentage penalty, and then apply an interest component which would be tied to the prime interest rate (e.g., prime interest rate plus 3%).

Recommendations:

The GDNT should consider implementing the following penalty structures for infractions described in Articles 13.1, and 13.2:

Article 13.1 Remit net tax amount for period while not registered, equal to VAT rate multiplied by taxable sales, less credit for purchases supported by VAT invoices; plus
Penalty of 10% of above net tax amount, plus
Interest on the net tax amount, at rate equal to prime rate plus 3%, calculated daily.

No input credits would be available to the business' customers.

Article 13.2 Remit amount of "tax" collected; plus
penalty amount equal to 100% of "tax collected, plus
Interest on the net tax amount, at rate equal to prime rate plus 3%, calculated daily.

No input credits would be available to the business' customers.

The GDNT should also consider reviewing their other penalties for tax non-compliance, based on the types of penalties described above.

10. Administrative Issues

Several consultants, including the Korean Knowledge Partnership Project, the Japan International Cooperation Agency (JICA), the International Monetary Fund, as well as Arthur Mann and Daniel Dietz of DAI (for the US AID Economic Policy Support Project) have made recommendations to improve the operation of the tax administration system in Mongolia. These recommendations dealt with the entirety of the tax administration system, and were each the result of quite thorough examinations. There is clear merit in these recommendations.

My comments are more narrowly focused, pertaining exclusively to the VAT administration system and recent proposals by the GDNT to enhance its effectiveness. Many of the following recommendations, particularly involving the reorganization of responsibilities within the GDNT and the Capital City Tax Office, will require careful planning and consideration and therefore cannot be done in the near future. However, they point to a direction for change for the GDNT to consider.

A. Organizational Issues/ Tax Officer Responsibilities

Current Organization

There are currently 5 main divisions in the GDNT:

1. Tax Administration and Methodology Division
2. Tax Collection Division
3. Tax Auditing Division
4. Resource Management and Internal Control Division
5. Information Processing and Automation Division

In addition to these divisions, there are three other offices that fall under the GDNT:

- Training and Service Centre
- State Registration Office
- Central Budget Revenue and Control Department (Large Taxpayer Office).

Also reporting to the GDNT are:

- The Capital City Tax Office (and the 9 district tax offices that report to it); and
- The 21 Aimag tax offices (and the 365 Soums that report to the Aimag tax offices).

VAT Unit Within GDNT

The Tax Administration and Methodology Division, and the Tax Collection Division each provide advice on all taxes. Although VAT has become the largest single tax

revenue source, there seems to be a very limited number of VAT specialists in the GDNT.

Recommendation

To improve the expertise in the VAT within the GDNT, the GDNT should consider increasing the number of VAT specialists and creating a sub-unit dedicated to assuming the VAT responsibilities of these two divisions. It could either report to the General Director Directly, or to the Director of one of the two above-mentioned Divisions.
Similarly, there should be a team established within the Tax Auditing Division that specifically involved in VAT audits (as described below).

Taxpayer Services

The cornerstone of all modern tax administration systems is voluntary compliance by taxpayers under a system that relies upon self-assessment by taxpayers. Essential for creating an environment in which self-assessment by taxpayers is possible is the establishment of an effective Taxpayer Services group, which provides taxpayers answers to their queries about the tax. This is particularly important for the VAT as it is a tax on transactions and thus requires daily decision-making and compliance by taxpayers.

Recommendation

The VAT sub-unit described above would be responsible for handling queries from taxpayers on the VAT.

Tax Collection Function in Large Taxpayers Office and Capital City Tax Office

The Large Taxpayer Office and the Capital City Tax Office handle most of the large taxpayers in the country. Currently, a key function of each of these offices is the Tax Collection function. A significant amount time each month is spent by staff in the Tax Collection Divisions meeting with and receiving the returns of taxpayers that are assigned to them. The main purpose of receiving the returns in this fashion is to verify that the returns have been properly filled in and that the returns superficially appear to be reasonable. It also gives the taxpayer an opportunity to make inquiries to their assigned staff officer about the operation of the tax.

However, this approach is very labour-intensive. Moreover, much of the time Tax Collection officers spend is with taxpayers that are compliant (and who do not need to be monitored so closely). It would be more efficient for these tax offices to receive the returns in drop-boxes, or by mail, and to have them processed in a more automated fashion. Under such a system, the returns would be received by the tax office, stamped, and recorded as having been received on the particular date. They would then be sent to a data entry section within the tax office, for the data on the return to be entered into the system. Some days following the due date of the return, the computer system would automatically generate lists of non-compliant taxpayers (i.e., stop-filers and non-payers).

Freed from the time-intensive task of receiving and superficially checking all taxpayers' returns, the staff of the Tax Collection Divisions in these offices could be more efficiently deployed following up with non-compliant taxpayers, or moved into audit to strengthen that function.

Recommendation

The receipt and processing of VAT returns should be done using the above procedures. Some of the Tax Collection staff in the Large Taxpayer Office and Capital City Tax Office should be assigned to VAT duties only, and deployed in pursuing VAT stop-filers, and non-payers, rather than receiving the returns of all taxpayers.

Audit

Based on discussions with GDNT officials, it appears that most VAT audits are comprehensive audits that are conducted with the Enterprise Income Tax audit. In addition, audits are done when refunds of VAT are requested. Finally, each month, desk audits are done checking the summaries of the sales and purchase book data submitted with each taxpayer's return.

These are all beneficial. However, it is important for the tax office to be seen to be out in the public visiting taxpayer's premises on a more regular basis looking at very specific issues – e.g., verifying that the taxpayer has the invoices to support its input tax credit claims for a particular return, and/ or that its sales invoices matches the sales figures stated on the return. This does not take the place of a comprehensive audit, but through such single-issue audits, routine errors and non-compliance can be identified and rectified early. In addition, by increasing the probability of a visit by the tax office through such shortened audits, voluntary compliance rises. Lastly, such audits can identify taxpayers who are more likely engaged in substantial underreporting or other tax types of tax evasion and should be the subject of comprehensive audits.

Recommendation

The GDNT should establish a separate VAT audit group in the tax offices, which would focus on single issue VAT audits.

B. Training Requirements

As noted in reports by other consultants, there is a substantial need for training of staff in all offices. The following would be the main priorities for VAT specific training:

- It is most important that VAT officers in all tax offices be given training in the basic operation of the VAT, including any changes made to the VAT coming out of the recommendations in this Report. A common theme that was noted in

discussions with tax officials and taxpayers was that many tax officials dealing with taxpayers are not well versed in VAT.

- Based on the recommendation above pertaining to audit, training should be provided to auditors in VAT single tax audit techniques;

- To the extent that the procedures for receiving VAT returns are changed, as per the recommendation above, procedures manuals will need to be prepared, and training provided to staff involved in the receiving and data entry of VAT returns. Training will also be required for existing Tax Collection staff who will become more involved in dealing with non-compliant taxpayers (i.e., requiring their compliance, working out payment arrangements of overdue taxes). In addition, to the extent that some of these officers will be moved into audit roles, training will be required.

- To the extent that the procedures for processing refund claims outlined in Section 1 of this Final Report are adopted, training will be required for audit staff in these procedures.

C. Assessment of new Tax Invoice/Computer Cross-checking Initiative

A new development in the VAT administration has been the requirement for businesses to use official VAT invoices. These VAT invoices have been serialized so that every invoice issued can be uniquely identified in the GDNT's computer system.

Under the new system, the vendor will issue one copy of the invoice to the customer, retain one copy for its own records, and send one copy to the tax office. The tax office will then enter the data from the invoices it receives. These can then be cross-checked against the input tax credit claims by taxpayers.

Assessment

The new serialized invoices are useful to track sales and purchases of businesses, and the cross checking system could be useful in preventing some forms of evasion – e.g., counterfeiting of purchase invoices, not reporting purchases in order to underreport sales. It is also useful as a means of creating a perception among taxpayers that the GDNT is carefully monitoring businesses sales, and therefore encourages voluntary compliance.

However, the entry and cross-checking of all invoice data, relative to other audit and compliance checking activities, does not appear to be a very efficient means of detecting non-compliance. Entry of selected data could be useful for random cross-checking purposes. But, rather than cross-checking all invoice data, it would be more cost effective to use the GDNT's resources on improved auditing, as discussed above. In particular, much evasion in Mongolia is most likely in the form of cash sales where no invoices are issued whatsoever. The invoice cross-checking will not catch this type of evasion.

Recommendation

The requirement to use serialized official invoices is beneficial. For businesses that print their own invoices electronically, they should be permitted to do so, using the invoices serial numbers assigned to them.

However, rather than entering data from all invoices received, the GNDT should selectively enter data, which it can then cross check on single tax audits.

This would give them more time and resources to focus on other compliance activities.